

# USAID Economic Growth Office Training Workshop

## Macroeconomic Policy Module

December 9, 2002






**I**

**What Are We Trying to Achieve  
In This Session?**

## *What We Are Trying To Achieve In this Session?*

- 
- **Introduce/review basic macroeconomic concepts and common measurements of macroeconomic conditions.**
  - **Review key policy determinants and how they affect macroeconomic conditions.**
  - **Examine characteristics of macroeconomic crises and possible policy responses.**
  - **Discuss tools to stimulate economic growth.**
  - **Apply these concepts to a case study.**

## **Macroeconomic Policies & Strategies Matter...**

- **They provide the environment and foundation for industry-level and firm-level activities.**
- **They can either stimulate or retard long-term growth.**
- **They directly or indirectly impact economic and personal well-being.**
- **They frame changes in approach.**
- **They yield different development paths.**

# MACRO STRATEGIES HAVE EVOLVED OVER TIME

1950 1960 1970 1980 1990 2000

**Industrialization  
and Economic  
“Take-off”**

**Development Planning**

**Import Substitution in Selected  
Regions and Countries**

**Export Promotion in Selected  
Regions and Countries**

**Basic Needs  
Fulfillment**

**Private Enterprise  
Development**

**Competitiveness,  
Globalization**

## Regional macro experiences have varied:

- **Latin America** – strategy changes, coping with instability.
- **East Asia** – basket case to miracle to financial excess.
- **South Asia** – challenged by widespread poverty.
- **Africa** – a “basic need” for economic growth foundations.
- **Middle East** – unleashing internal and regional markets.
- **Transitioning** – reversing basic economic frameworks .

# II

**Why Do We Need to Understand  
and Use Macroeconomic Concepts  
and Data?**



## *Why Do We Need to Understand and Use Macroeconomic Concepts and Data?*

***Macroeconomic concepts*** give us the theoretical framework, examples of experience, and best practices needed to make sound policy and program choices.

***Macroeconomic data*** provide broad measures of economic performance as well as a snapshot of a country's economy - its achievements, potential, and areas of vulnerability.





*Why Do We Need to Understand and Use Macroeconomic Concepts and Data?*

## **Common Measurements of Economic Activity and Growth:**

- ◆ GDP and GNP
- ◆ Per capita GDP
- ◆ Growth rates (Real versus Nominal)

## **Common Measurements of Inflation:**

- ◆ GDP deflator
- ◆ Consumer Price Index (CPI)
- ◆ Producer Price Index (PPI)



*Why Do We Need to Understand and Use Macroeconomic Concepts and Data?*

## **Interest Rates**

- ◆ **Nominal interest rates.**
- ◆ **Real interest rates.**
- ◆ **The relationship between interest rates and the pace of economic activity.**



*Why Do We Need to Understand and Use Macroeconomic Concepts and Data?*

## **Characteristics of an Economy**

- ◆ **Structure - the dominant economic activities.**
- ◆ **Dependence - Reliance on natural resources or certain sectors of the economy (oil, commodities, tourism, etc.).**
- ◆ **Openness – Integration with outside world.**
- ◆ **Growth Prospects - Driven by fundamental strengths & weaknesses.**



*Why Do We Need to Understand and Use Macroeconomic Concepts and Data?*

## **Measures of the External Sector**

- ◆ **Exports and imports as a share of GDP.**
- ◆ **Trade account/current account.**
- ◆ **Capital account.**
- ◆ **International reserves.**
- ◆ **Balance of payments.**



*Why Do We Need to Understand and Use Macroeconomic Concepts and Data?*

## **Measures of Poverty and Income Distribution**

- ◆ **Poverty rate (national, rural, and urban).**
- ◆ **Poverty gap.**
- ◆ **Population below \$1 a day and \$2 a day.**
- ◆ **The Gini Index.**
- ◆ **Percent share of income or consumption by quintiles or deciles.**

# **III**

**How Do Key Policy  
Determinants Affect  
Macroeconomic Conditions?**



## **The Key Macroeconomic Policy Arenas:**

- **Monetary Policy**
- **Fiscal Policy**
- **Foreign Exchange Policy**
- **Trade and Investment Policy**



## **What is monetary policy?**

- ◆ It's influencing economic activities through the control of the money supply (typically the role of the Central Bank).

## **What are the tools of monetary policy?**

- ◆ Open market operations.
- ◆ Discount window.
- ◆ Reserve requirements on financial institutions.





**When do central banks/governments pursue “tight” monetary policy?**

**When is “expansionary” monetary policy appropriate?**

*The “ideal” monetary policy outcome is steady, sustainable economic growth that is accompanied by low inflation.*



## **What is fiscal policy?**

**It's managing the government's budget (typically the job of the Treasury or Ministry of Finance).**

## **Are budget deficits always bad?**

## **What are the effects of chronic budget deficits?**



## **Some adverse impacts of sustained budget deficits:**

- **“Crowding out.”**
- **“Monetizing” deficits.**
- **How are government deficits related to balance of payments conditions?**



## Foreign Exchange Policies

*Real exchange rate* versus *nominal exchange rate*.

What is a “competitive” exchange rate?



## **The most prevalent exchange regimes:**

- **Fixed exchange rates**
- **Flexible exchange regime**
- **Variations of fixed and flexible foreign exchange regimes**



## **Best Practices in Exchange Rate Management**

- **Maintain an exchange rate that facilitates equilibrium in the overall balance of payments.**
- **Establish monetary authority credibility and independence**
- **Keep FX reserves stable and at sufficient levels.**



## Trade and Investment Policies

Two extremes are possible:

**Open Economy** and **Closed Economy**

How do you describe these variants?

*Most developing countries are moving toward the open economy model with different degrees of liberalization.*

## *Putting it all together...*

### **Key Macroeconomic Policy Areas:**

- ◆ **Monetary Policy**
- ◆ **Fiscal Policy**
- ◆ **Foreign  
Exchange Policy**
- ◆ **Trade and  
Investment  
Policy**

### **Macroeconomic Outcome/Measurements:**

- **FX Competitiveness**
- **Trade Balance**
- **FDI Flow**
- **Capital Account & Reserves**
- **Balance of Payments**
- **Interest Rates**
- **Growth**
- **Inflation**
- **Government's Fiscal Health**
- **Poverty and Social  
Conditions**





## *How Do Key Policy Determinants Affect Macroeconomic Conditions?*






**What can policymakers control and not control in terms of macroeconomic policies and outcomes?**

- money supply
- perfect capital mobility
- fixed exchange rate

# **IV**

**What Do You Do  
When Things Go Wrong?**

**A macroeconomic crisis is usually characterized by:**

-  **Hyperinflation**
-  **Banking sector problems and bank runs**
-  **Currency crisis**
-  **Capital flight**
-  **Balance of payments difficulties**

## **Warning Signs and Symptoms of Crisis**

- ◆ **Over-borrowing in the private sector**
- ◆ **Rapidly rising real exchange rate (overvalued)**
- ◆ **Deteriorating fiscal balances**
- ◆ **Overheated domestic demand and speculation in nonproductive sectors (e.g., real estate)**

## **Warning Signs and Symptoms of Crisis . . .**

- ◆ **Capital account problem indicators:**
  - **Declining reserves**
  - **Real interest rate differential  
(domestic and the world)**
  - **Rising foreign debt, both public and  
private**
- ◆ **Downgrading of sovereign risks**

## **Examples of shocks:**



**Latin America debt crises in the 1980s: Rising world interest rates and falling commodity prices.**



**East Asian macroeconomic crises (financial contagion) in 1997: Thai Baht devaluation, fear of competitive devaluations and lost of investor confidence in the region.**

**A BOP crisis occurs when outflows of foreign exchange exceeds inflows, i.e., the country is spending more than what it produces and can borrow from abroad.**

## **Managing Shocks and Weathering Crises**

### *Short-term Options for Governments*

- ← **Draw down foreign exchange reserves (usually exhausted quickly) ➡ devaluation.**
- ← **Impose capital controls.**
- ← **Introduce higher tariffs or surcharges.**
- ← **Borrow foreign exchange to cover short term liabilities (IMF).**

## **Managing Shocks and Weathering Crises**

### *Long-term Options for Governments*

- ➔ **Restructure foreign debt – coordinate with lenders to roll over or forgive short-term debts.**
- ➔ **Implement fundamental shifts in monetary and fiscal policies.**
- ➔ **Build strong financial and regulatory institutions.**
- ➔ **Improve monitoring of external liabilities in the future.**



## **Managing Shocks and Weathering Crises . . .**

### ***Roles of the IMF***

- ◆ Provides short-term liquidity to countries with BOP problems.
- ◆ Imposes *Conditionalities* on loans granted in installments (tranches).
- ◆ Requires structural adjustment.

## **Managing Shocks and Weathering Crises . . .**

### *Social Impacts of Stabilization*

- ✉ **Impacts of monetary contraction (on incomes).**
- ✉ **Impacts of fiscal contraction (on subsidies and social programs).**
- ✉ **Disproportionate burden and suffering among the poor.**
- ✉ **Ongoing debate on IMF's "typical" approach to structural adjustment, (e.g., whether economy should contract or expand during adjustment).**



V

**What Do You Do to Stimulate  
Growth?**

## Lessons Learned in Pursuing Sustainable Development:

### *Conventional Neoclassical “Wisdom”*

- **Macroeconomic stability is a prerequisite for sustainable growth.**
- **A growing private sector will yield the most robust economic growth.**
- **Liberalizing trade and reducing government interference facilitates private sector-led growth.**

## Lessons Learned in Pursuing Sustainable Development:

### *The “New” Consensus*

- ◆ While the “consensus” has merit, a rethinking of the role of government in development is needed.
- ◆ Other important components of economic growth should receive more attention – industrial policy and technology transfers, human capital formation, competition policies, and the institution building.
- ◆ These policies require a new role for the government. However, the appropriate degree and type of government involvement is still being debated.

## Lessons Learned in Pursuing Sustainable Development:



### *Sound Macroeconomic Policies*

- ➔ **Responsible public finance (regarding deficit spending, tax collection, etc.).**
- ➔ **Stable monetary policies.**
- ➔ **Sound management of external finance.**
- ➔ **Building strong financial institutions and capital markets .**

## Lessons Learned in Pursuing Sustainable Development:

*Many Effective Strategies are Built Around  
Two “New” Development Concepts\**



**Competitiveness**



**Globalization**

\* (They’ve actually always been around)

# COMPETITIVENESS: WHAT IS IT?

Competitiveness is felt at the level of the firm & industry.

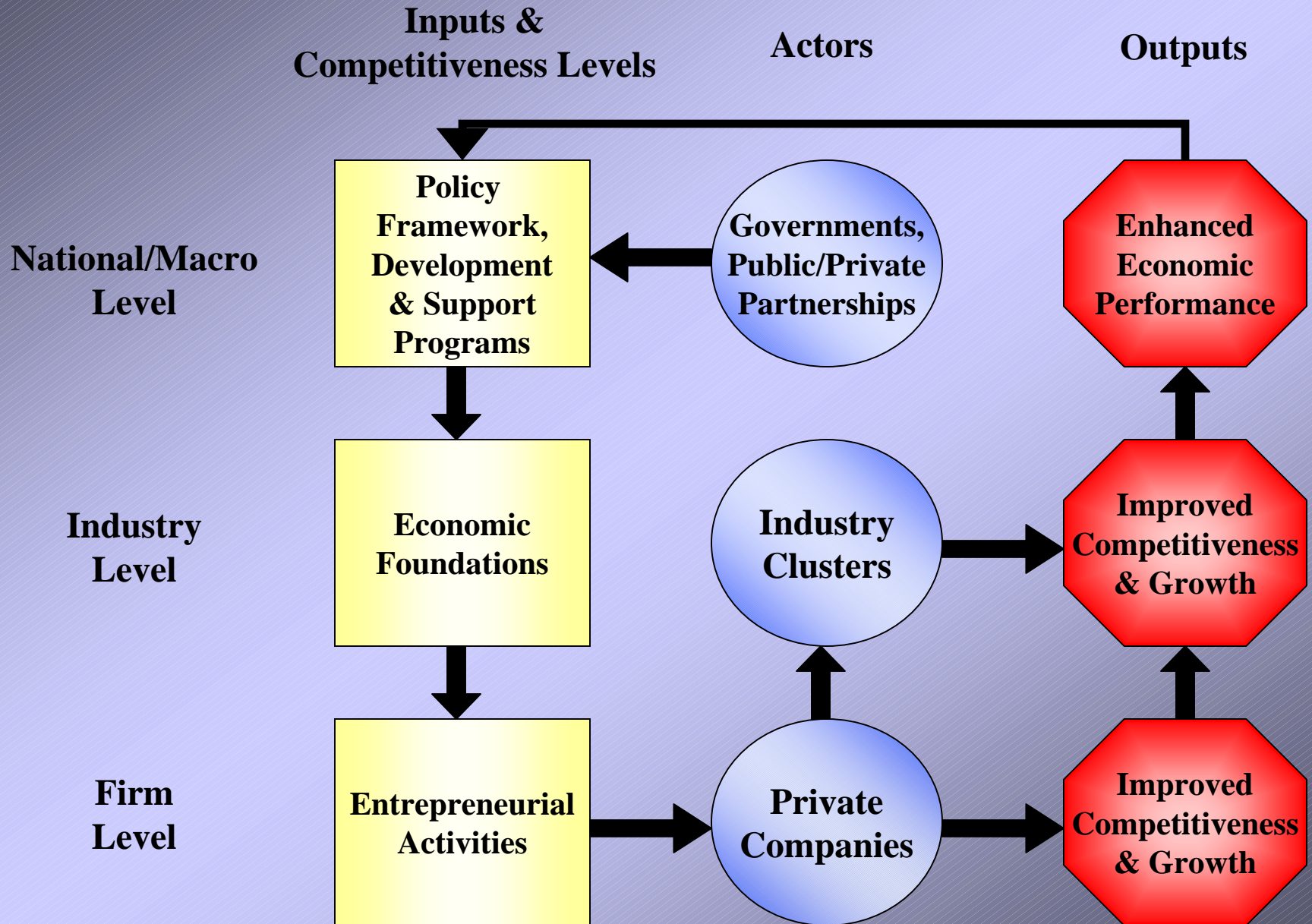
*Traditional Measure:* Productivity/efficiency

*Modern Measure:* Holistic ability to serve clients better than competitors (productivity/efficiency *plus* information, agility, supply chain management, service, etc.)

While competitiveness is driven by firms and industries, they interact with the economy and society in a cause and effect manner.



# The “Virtuous” Flow of Competitiveness

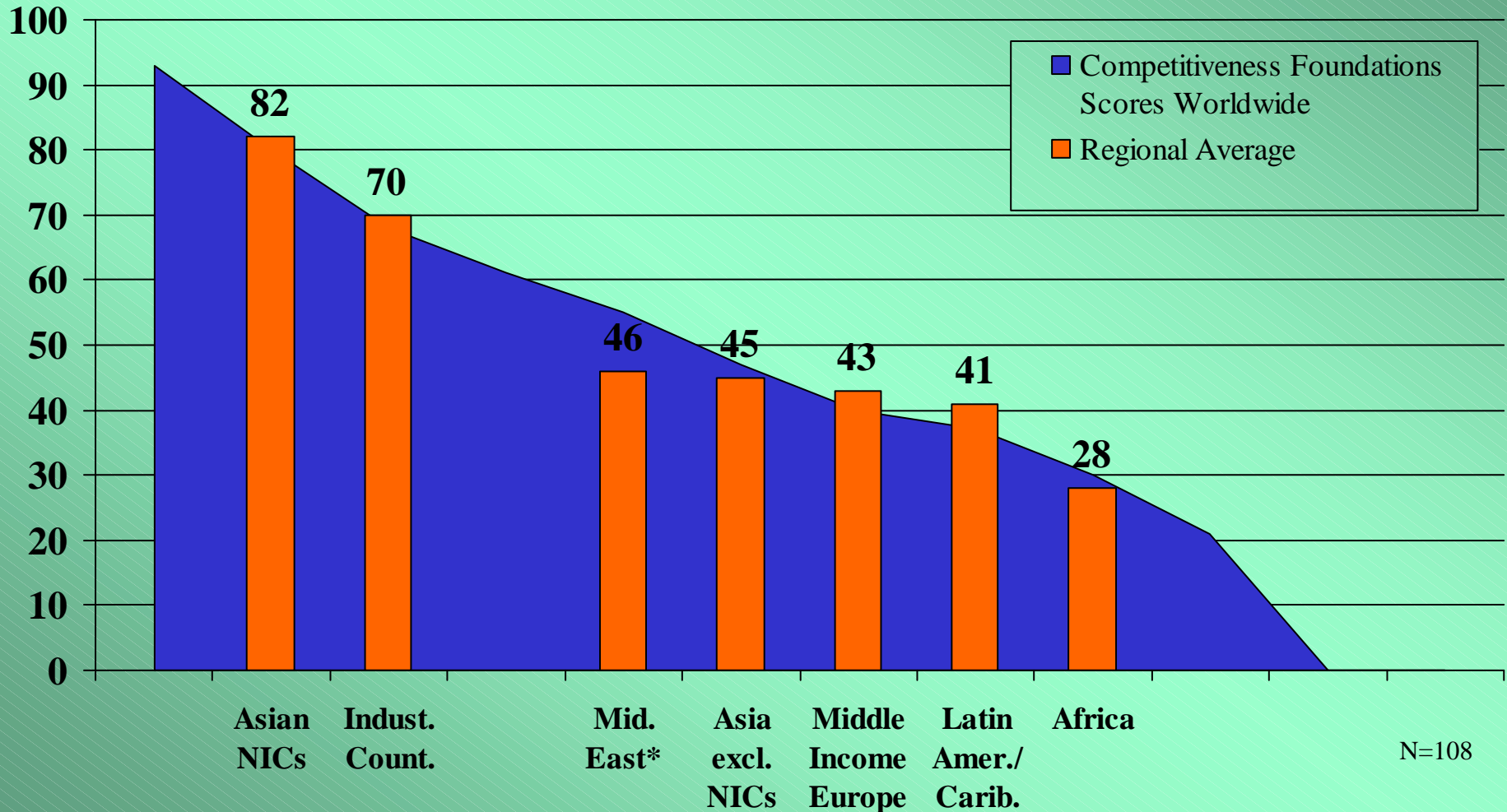




# Key Indicators of Competitiveness

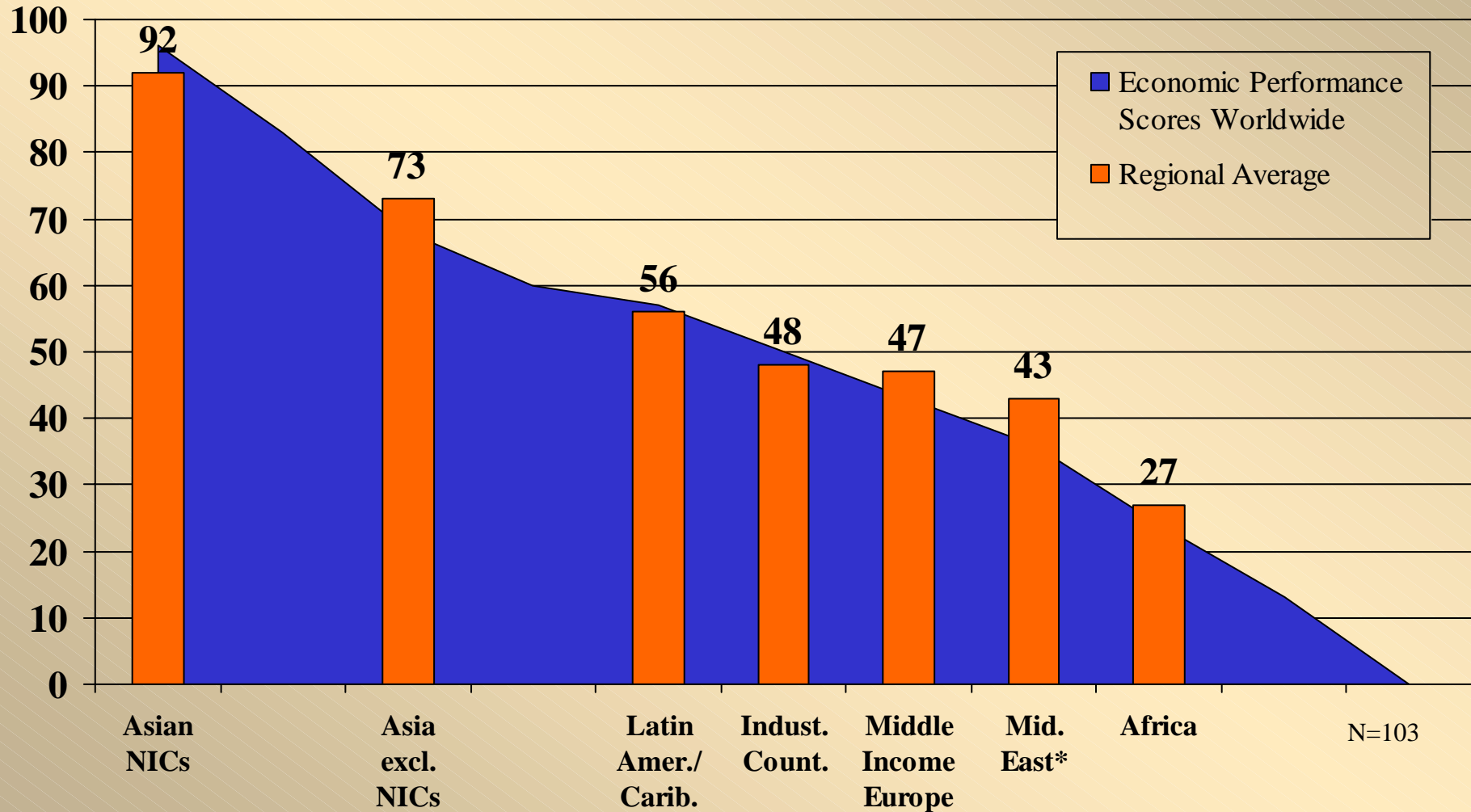
- **Capital formation (amounts of saving, investment, foreign investment)**
- **Openness of economy, export growth attraction of new investment.**
- **Human resource capabilities**
- **Technology infrastructure (scientists, engineers, technicians)**
- **Physical infrastructure (electricity, telephones, road density)**

# Global Benchmarking Scores: Competitiveness Foundations



\* Excluding Lebanon

# Global Benchmarking Scores: Regional Economic Performance



\* Excluding Lebanon

# GLOBALIZATION

**Other than policy differences, national boundaries are no longer relevant to the global economy.**

## **Goods and Services Markets**

- **Products are now produced and distributed globally.**
- **The distinction between goods and services is now blurred.**
- **Producers now compete directly with the world's “best” producers.**

## **Factor Markets**

- **Technology and information have surpassed labor, capital, and resources in importance.**
- **All factors now effectively flow freely across borders.**

# Globalization Heightens Competitiveness Drivers

## Challenges

**Competitive Pressures**

**Need to Find New Products & Markets**

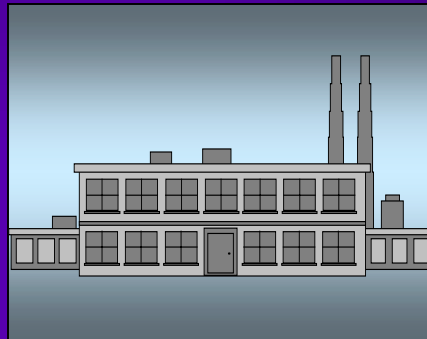
**Need to Upgrade Skills, Technology, & Management**

## Opportunities

**Larger, More Diversified Markets**

**Access to Technology, Capital, & Alliances**

**Breakout from Traditional Practices**



# Promoting Competitiveness in a Global Market

## Improve the policy environment:

- Create clear rules of the game
- Install prudent macro management
- Reduce disincentives and policy biases at the sectoral level
- Minimize transaction costs at the firm level

## Nurture competitive industry clusters :

- Map competitive clusters
- Engage stakeholders
- Define initiatives
- Identify champions
- Implement initiatives

## Enhance economic foundations:

- Work force
- Capital
- Technology
- Infrastructure
- Institutional support system





**VI**

**You're in the Hot Seat!**



# CASE STUDY “QUIZ”

**You are key USAID staff in the nation of Parador, a close ally of the United States. An economic policy issue has emerged, and you have to brief the Mission Director and/or Ambassador.**

- ☒ **Please quickly review the material prepared by the Embassy’s Economic Attaché.**
- ☒ **Discuss the issue with your colleagues.**
- ☒ **Identify a group presenter.**
- ☒ **Determine and record key points on flipchart.**
- ☒ **Presenter, please present your arguments, in five minutes or less! Your promotion depends on it!**

# USAID Economic Growth Office Training Workshop

## Macroeconomic Policy Module

December 9, 2002

